pwc

羅兵咸永道

Standard Setting Department
Hong Kong Institute of Certified Public Accountants
37th Floor, Wu Chung House
213 Queen's Road East
Wanchai, Hong Kong

2 December 2016

Dear Sir

Post-implementation Review of Accounting Guideline 5 Merger Accounting for Common Control Combinations

We are responding to your invitation to comment on the post-implementation review of Accounting Guideline 5 Merger Accounting for Common Control Combinations ("AG 5") on behalf of PricewaterhouseCoopers.

We agree that the principles, procedures and example set out in AG 5 are generally helpful as a guidance on the accounting practice in accounting for certain common control combinations. We also fully support the HKICPA in considering the improvement to AG 5 given that the definition of business combination under HKFRS 3 has revised and there are certain implementation challenges on the application of AG 5.

Implementation challenges

We have summarised the main challenges with regard to the application of AG 5. These are briefly set out below and expanded on in the Appendix:

1. Restatement of Comparatives
   a) Company financial statements
      It is unclear from AG 5 whether restatement of comparatives is applicable for company financial statements.
   b) Consolidated financial statements
      AG 5 mandatorily requires the restatement of comparatives in the consolidated financial statements but there may be difficulties in the application when there is no separate books and records for the historical data. The restatement of comparatives may not provide relevant and useful information to financial statements users in certain situations. It may distort the performance trend of the legal group as a reporting entity and make readers difficult to follow.

We recommend that the restatement of comparatives should be optional in both company and consolidation level.

2. Presentation of Minority Interests ("MI")
   In general, presenting MI from controlling party's perspective is relevant as the same figures are used in the controlling party's consolidation accounts. However, sometimes historical MI figures from controlling party's perspective as comparatives are irrelevant to the reporting entity or even misleading. For example, the percentage of equity owned by the MI after the business combinations under common control ("BCUCC") is different from that owned by the MI from the controlling party's perspective before the BCUCC

due to pooling of interests by both the controlling party and MI. In such case, there is no real transaction between controlling and minority shareholders upon the BCUCC. The EPS figures calculated based on MI figures from the controlling party's perspective before the BCUCC and calculated based on MI figures from the reporting entity's perspective after the BCUCC are therefore not comparable.

3. Definition of Common Control
Under AG 5, if the businesses being combined are ultimately controlled by the same party, it will fall under BCUCC. There are a lot of business combinations among state-owned enterprises ("SoE") in China. While they are all ultimately under the common control of the State, the combining businesses may not be under the same corporate group or even in the absence of any one single party deciding and concluding the combination. We observe that there is diversity in practice in considering whether business combinations among SoE are BCUCCs because the scope of BCUCC under AG 5 may be too board to cover these types of transactions and merger accounting may not be faithfully reflect the economics of the transactions. Chinese Implementation Guidance has specific guidance on types of SoE transactions fall under BCUCC. This may create a GAAP difference between HKFRS and CAS.

4. Predecessor Value at the "Controlling Party's Perspective"
AG 5 states that the book value of the assets and liabilities of the combined businesses should be those recorded in the consolidated financial statements of the controlling parties, but it does not define which level of the controlling party should be considered. It is more accurate in using the predecessor value from the ultimate controlling party's perspective as it always reflects the results of the performance under the current controlling party, and this also provides a consistent result regardless of the level of structure. However, sometimes there are challenges in identifying such predecessor value. The ultimate controlling party maybe an individual not preparing his consolidated financial statements. The goodwill from previous acquisition may cover different group entities and it would be difficult to allocate goodwill to the lowest combined entity level. There is diversity in practice in determining which predecessor value is used when there are multiple layers of intermediate holding companies.

We recommend that additional guidance on points 2 – 4 above to address these practical challenges and at the same time to avoid cherry picking is required.

We expand on our comments above and respond to the specific questions posed in the invitation to comment are attached as the Appendix to this letter. They include some suggestions on areas that more general guidance under AG 5 may be required in order to address the application issues.

If you have any questions in relation to this letter please do not hesitate to contact Shelley So (2289 2955) or Elza Yuen (2289 2314).

Yours faithfully

PricewaterhouseCoopers

PricewaterhouseCoopers

www.pwc.co.uk

Accounting Guideline 5 - Merger Accounting for Common Control Combinations

- Post-implementation review

December 2016

pwc

Question 1

Please tell us:

(a) about your role with respect to financial reporting (for example, preparer of financial statements, auditor, valuation specialist, user of financial statements and the type of user, regulator, academic, accounting professional body, etc) and your experience with accounting for common control combinations.

<u>Question targeted at preparers of financial statements</u>

Please tell us:

(b) (i) what are the principal activities of your company;
(ii) whether your company prepares financial statements under HKFRS; and
(iii) how often have you encountered common control combination transactions?

Question 1 response

- We are auditors from a professional accounting firm.
- Our responses focus on the questions targeted at preparers of financial statements in this Request-for-information ("Rfi"). Our responses cover both BCUCC and recapitalisation. BCUCC refers to a transaction to combine two or more businesses together that are under common control. Whereas recapitalisation is to establish a shell company to be inserted above a single reporting entity, either a business or an entity, as the new parent without change in shareholders' structure nor control of the reporting entity.
- Common control combination transactions are commonly seen in IPOs and other group reorganisations.

Question 2

(a) What are the nature and purpose of the common control combination transactions that you encountered? What accounting method (for example, acquisition accounting under IFRS/HKFRS 3 or merger accounting) have you elected to use for these transactions? Why was that method elected?

(b) If merger accounting was applied to account for common control combinations, did you apply AG5? Please explain why or why not.

Question 2(a) response

- Common control combination transactions are typically entered into to improve the efficiencies of the group management and operation, to implement more efficient tax planning structures, or for the preparation of an IPO.
- Merger accounting is more frequently used in reorganisation and common control combination transactions. Financial institutions in which majority of the underlying assets have been measured at fair value, acquisition accounting may prefer.
- Merger accounting method is normally elected in considering:
  - BCUCCs are purely for internal reorganisation purpose.
  - Consistent accounting records for consolidation purpose.
  - Time and costs saving for not having fair value estimation.
  - BCUCCs are executed in the preparation for an IPO as historical information for the track record period is required pursuant to the Listing Rules.
  - Consistent accounting policy must be applied to all BCUCCs once been selected. For example, if the listed company had adopted merger accounting upon the IPO, merger accounting must be applied to all its subsequent BCUCCs, unless voluntary change in accounting with retrospective impact.
  - To avoid GAAP differences as merger accounting must be applied for BCUCCs under CAS.

Question 2(a) response (Cont'd)

- Acquisition accounting method is normally elected in considering:
  - BCUCCs executed with similar objectives and terms as business combinations with unrelated 3rd party, i.e. arm's length transactions.
  - Majority of the underlying assets has been measured at fair value, e.g. for financial institutions.
  - Obtain new external financing after the business combination.
  - Consistent accounting policy must be applied to all BCUCCs once been selected.

Question 2(b) response

- HKFRS preparers generally adopt AG5 for merger accounting where applicable and appropriate to circumstances, otherwise, be prepared to explain the reasons for non application. However, inconsistent implementation of AG5 may occur under certain circumstances due to lack of clear guidance or the guidance under AG 5 does not faithfully represent the transaction. For example:

<u>Interspersing a shell company</u>

AG5.5 states that interspersing a shell company is not addressed in AG 5. Recapitalisation which is not BCUCC would not apply AG 5.

<u>Company level financial statements</u>

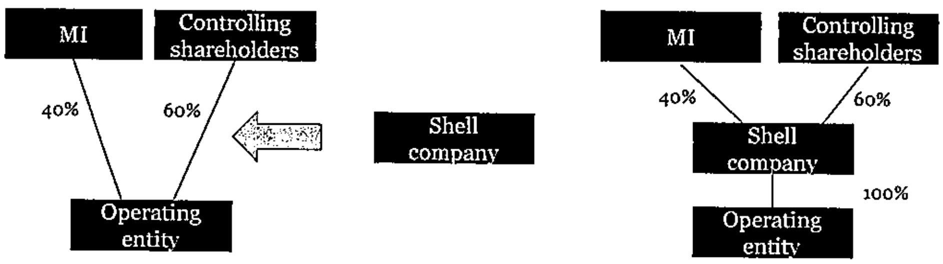
AG5.7 is clear that comparative figures have to be restated in the consolidated financial statements. However, there is no clear guidance for the comparatives in the company level financial statements if the business combinations occur within the company. There is diversity in practice on the restatement of comparatives in the company level financial statements.

Under CAS, comparative figures must be restated in the consolidated financial statements. However, no restatement is allowed in the company level financial statements.

Question 2(b) response (Cont'd)

<u>Accounting for minority interests from controlling party's perspective</u>

AG5.10 and AG5.11 state that the book value of the assets and liabilities and the results of the combined businesses should be those recorded in the consolidated financial statements of the controlling party, including the MI.



For interspersing a shell company between ex-shareholders of the operating entity (including controlling and minority shareholders) and the operating entity. The shell company is the reporting entity holding 100% of the operating entity without minority shareholders. Hence, no presentation of minority interests before and after the reorganisation could be more faithful in reflecting its operating results attributable to its shareholders.

Question 2(b) response (Cont'd)

Accounting for minority interests from controlling party's perspective (Cont'd)

Under CAS, only the controlling party view is allowed for the presentation of minority interests. The issue on presentation of MI may not be so common in China as the listing company must be an existed company having operation and cannot be a shell company.

Question 2(b) response (Cont'd)

Predecessor value at the "controlling party's perspective"

AG5.9 requires the net assets of the combining businesses at the carrying amounts as if the consolidated financial statements of the controlling parties had been prepared.

If controlling party is an individual not preparing consolidated accounts, market may use books and records of the combined entities as the predecessor value for merger accounting.

Question 3

(a) Appendix 1 of this RfI outlines the principles and procedures for merger accounting, as extracted from paragraphs 4 to 13 of AG5. Are these principles and procedures clear? If not, what is unclear or missing? Please specify the reasons behind your answer.

Questions targeted at preparers of financial statements

(b) What are the main challenges in applying the principles and procedures in paragraphs 4 to 13 of AG5? Please explain why it is challenging and how you have dealt with those challenges.

Question 3 (Cont'd)

(c) Using Illustration 1, which entity have you identified as the 'controlling party' when applying AG5 in the consolidated financial statements of P3, and what were the considerations that led you to this determination? For example, please specify whether your considerations included understanding the: (i) purpose of the financial statements; (ii) underlying nature and economic substance of the transaction; (iii) changes in the common controlling party during the periods presented (if any); (iv) cost considerations (if any); (v) whether the transferred entity was previously purchased from a third party (that is, goodwill was recognized when the acquired entity entered the group); and/or (vi) any other considerations.

(d) What are the main challenges in accounting for a common control combination using the existing book values from the controlling party's perspective? Please explain why it is challenging and how you have dealt with those challenges.

Question 3(a) response

Reference	Unclear principles
Para. 5	More elaboration on the recapitalization concept may be helpful. "In practice, these transactions .... a principle similar to that for a reverse acquisition" maybe misleading as combining a new entity without business is no longer business combination under the revised HKFRS 3. This should be updated in accordance with HKFRS 3. Should the ultimate controlling party or the business own predecessor value be used in a recapitalisation. There is currently no clear guidance.
Para. 7	• "......are included in the consolidated financial statements..." Not clear whether restatement of comparatives under AG 5 applies to the company level financial statements. • "Combining entities or businesses" creates confusion with para. 5 and not consistent with the definition of business combination under the revised HKFRS 3 Appendix A "....obtains control of one or more businesses....". This should be updated in accordance with HKFRS 3.

Question 3(a) response (Cont'd)

Reference	Unclear principles
Para. 9	Unclear at which level should the "controlling parties' perspective" be applied in the situation of multiple layers of intermediate holding companies. Should the predecessor value at the ultimate controlling party or different predecessor value at the intermediate controlling party be adopted. There is diversity in practice using different predecessor values at different levels. Some may use the ultimate controlling party level and some may use lower intermediate holding company levels or the lowest combined entities' level due to different practical difficulties or other reasons. For example, controlling party is an individual, hence, books and records of the combined entity itself are used. Intermediate controlling party level is used because different GAAPs are used in preparing consolidated financial statements of higher level; or no information at higher level to allocate goodwill down to the combined entity level; or different management teams to manage the operations at higher level. Additional guidance may be useful to eliminate the inconsistency and avoid cherry picking.

Question 3(b) response

Main challenges

- Definition of common control for state-owned enterprises ("SoE")
  - ➢ BCUCC under AG 5 is defined as "a business combination in which all of the combining entities or businesses are ultimately controlled by the same party or parties....."
  - ➢ SoE "Ultimately controlled by the same State" falls into the definition of common control under AG 5.
  - ➢ There are a lot of business combinations among SoE in China. Combining businesses may not be under the same corporate group or even in the absence of any one single party in deciding and concluding the combination. Even combinations based on the State's direction, may still be at arm's length terms.
  - ➢ Scope of SoE may not be always clear, e.g. all of the top ten shareholders are state owned and each of them has significant influence only.
  - ➢ There is diversity in practice how to interpret the scope of common control under HKFRS.
  - ➢ Chinese Implementation Guidance issued by MoF provides specific guidance in determining which types of SoE transactions that fall into the scope of BCUCC. Thus there are differences in the interpretation of common control between CAS and HKFRS.

Question 3(b) response (Cont'd)

Main challenges

- Definition of common control for a business transfer conditional upon an event resulting in loss of control, e.g. a REIT IPO.
  - ➢ HKFRS 3.B1 states that a common control transaction is one in which all of the entities/ businesses involved are ultimately controlled by the same party or parties both before and after the transaction, and that the control is not transitory.
  - ➢ In a REIT IPO, the formation of the trust is conditional upon IPO. Proceeds received from the IPO will be injected into the trust for the acquisition of the business from the controlling party. In this situation, the completion of the reorganisation is conditional upon IPO of which there is a change in controlling shareholder.
  - ➢ There is diversity in practice how to interpret the scope of common control under HKFRS whether transfer of business conditional upon IPO with change in controlling shareholder is a common control transaction.

Question 3(b) response (Cont'd)

Main challenges

- Restatement of comparative figures
  - ➢ No separate books and records, especially for the combining business which was only part of a legal entity before the combination.
  - ➢ Allocation of costs and determination of tax positions may involve significant management judgement.
  - ➢ Frequent common control combinations with corresponding frequent restatements of comparatives makes readers difficult to follow the performance trend of the reporting entity.
  - ➢ Different directors managed the combining businesses subsequent to the BCUCC and they may have hesitation to approve the financial statements with comparatives restated as they did not manage such businesses previously.
  - ➢ Not all controlling parties prepared HKFRS consolidated financial statements in prior years as they maybe individuals or they adopted other GAAPs for preparing consolidated financial statements. The carrying amounts of the combined businesses have to be incorporated as if such HKFRS consolidated financial statements had been prepared are challenging without the use of hindsight.

Question 3(b) response (Cont'd)

Main challenges

- Presenting minority interests ("MI") from controlling party's perspective
  - ➢ In general, presenting MI from controlling party's perspective is relevant as the same figures are used in the controlling party's consolidated accounts. However, sometimes, historical MI figures from controlling party's perspective are irrelevant to the reporting entity or even misleading. For example, for IPO, the reporting entity issued shares to both controlling and minority shareholders at the same time for the reorganisation purpose. There is no MI from the reporting entity perspective and also no real transaction between controlling shareholder and MI. It may be misleading to have MI before the reorganisation and as if there is transaction with MI upon the reorganisation.

Question 3(c) response

- P2 won't be identified as the controlling party as it does not control S2 after the BCUCC.
- In most cases, preparers would identify UP as the controlling party. The consolidated financial statements of UP reflects the performance of S2 under the control of UP, the current controlling party. While the consolidated financial statements of IP reflected the performance of S2 under the previous controlling party.
- If UP is an individual who does not prepare consolidated financial statements, the consolidated financial statements of IP could be used for IFRS. However, HKFRS preparers still have to prepare the financial statements on an as-if basis in accordance with AG5.

Question 3(d) response

- Please refer to responses to Question 3(b) under slides #15 to #18 for the main challenges.
- Regarding how to deal with those challenges,
  a) Appropriate basis of allocation would be considered in splitting the books and records of the combining entity and clear disclosures of the allocation basis should be made in the financial statements.
  b) Considering the purpose and impact of the financial statements and from the reporting entity's perspective, whether there is a real transaction between the controlling shareholder and MI during the BCUCC to determine the presentation of MI before the BCUCC.
  c) The issue of diversity in practice is likely to be more serious for private companies, including the use of predecessor value, restatements of comparatives and MI presentation.

Question 4

(a) Is the accounting for minority interests clear in the principles and example of AG5? If not, what do you think is unclear or missing? Please specify the reasons behind your answer.

Questions targeted at preparers of financial statements

(b) What are the main challenges in accounting for minority interests in a common control combination under AG5? Please explain why it is challenging and how you have dealt with those challenges.

(c) Using Illustration 2, and assuming that the common control combination had taken place in the current year, please specify how you have recorded the minority interests for entity S2 in the:

(i) consolidated balance sheet of entity P3 as at the current and prior year end dates; and

(ii) consolidated income statement of entity P3, i.e. profit attributable to the minority interests, for the current and prior years.

What were the considerations that led you to this determination? Do you generally consider the level of controlling party when accounting for minority interests in common control combinations?

Question 4(a)&(b) response

- It is unclear from AG5 at which level should the "controlling party's perspective" be applied to account for minority interests when there are multiple layers of control in the group structure.
- For consistency, it is preferable that the predecessor value and the MI should be the one presented in the same set of consolidated financial statements of the same controlling party. For example, if predecessor value using the consolidated financial statements of the ultimate controlling party, MI presented should be the MI of the ultimate controlling party. However, such presentation of MI may not reflect the MI from the reporting entity's perspective.

Question 4(c) response

- Same reasons as slide #19.
- In most cases, preparers would account for the minority interests from the perspective of ultimate controlling party – UP.
- There is actual transaction with MI consider P3 issued 5% shares to MI in return for its 7% shares in S2.
- MI shares 7% of the net assets in the consolidated balance sheet in prior years. 7% profits for the prior years and for the period prior to the BCUCC in the income statement of entity P3 were attributable to MI.
- Upon completion of the BCUCC, there will be no MI in the balance sheet. The change in MI from 7% to nil will be accounted for as equity transaction with minority interests in the current period. Hence, for current year's profits: 7% attributable to MI up to the date of BCUCC and no further attribution after the BCUCC.
- The main considerations leading to the above treatment are from the "controlling party's perspective" as a guidance in AG 5 and the transaction with minority interests is a real transaction at the reporting entity level.

Question 5

(a) What are the main challenges in presenting the financial statements under the merger accounting principle, which assumes that no acquisition has occurred and that there has been a continuation of the risks and benefits to the controlling party? Please explain why it is challenging and how you have dealt with those challenges.

Question 5 response

- Please refer to responses to Question 3(b) and 3(d) under slides #15 to #18, and slide #20, respectively, for the details.

Question 6

(a) In the common control combinations that you have encountered, what forms of consideration are paid for the acquired entity – is it cash, shares, a combination of cash and shares, contingent consideration, or other forms of consideration?

(b) The example in AG5 illustrates that the consolidated financial statements of the comparative year are restated as if shares were issued in the comparative year following the principle of merger accounting. If you have encountered forms of consideration other than shares, how have you accounted for it in the current and comparative years?

Question 6(a) response

There are various forms of consideration:

- Cash
- Shares (including ordinary shares, preference shares and non-redeemable convertible preference shares)
- Convertible bonds
- Contingent consideration
- Combination of any of the above

Question 6(b) response

- Shares consideration as equity is accounted for as if the shares had always been issued since the combining entities first came under common control following the principle of merger accounting.

  The example in AG5 illustrates that the share capital in the consolidated financial statements for all periods presented represents the share capital of the reporting entity adjusted for the shares issued for the purposes of the BCUCC, i.e. as if those shares had always been issued. However, it is more meaningful for the presentation to base on the legal form, i.e. a reclassification from merger reserve to share capital upon its issuance.
- Non-equity considerations are accounted for as contribution/distribution on the transaction date in the current year since there is no contractual rights as assets or obligations as liabilities before the actual transaction occurs.

Question 7

(a) What are the main challenges in preparing, auditing or enforcing the disclosures required by AG5 (paragraphs 7(a) to 7(h) above) and why?

Question targeted at preparers of financial statements

(b) What are the practical challenges you would foresee in applying additional disclosures similar to those in Appendix 2 and/or applying disclosures as suggested in paragraphs 7(i) to 7(k) above?

Question 7(a) response

The main challenges in auditing the disclosures required by AG 5 are:

- In the absence of historical financial information (i.e. no separate books and records), management apply significant judgement to determine the basis of allocation. It is also difficult to ensure completeness of records for accounting purpose.
- Unclear guidance on the definition of common control for SoE and there is diversity in practice on how to interpret the scope of AG5, especially for SoE transactions involving different ministry/provincial.
- Large volume of work to audit the restatement of comparatives.

Question 7(b) response

- Disclosures (g) and (h) may not be very relevant and meaningful to users of the financial statements.
- The suggested qualitative disclosure (i) is good to have but may become only a generic description by preparers instead of being case specific.
- The suggested disclosure (j) is good to have.
- The suggested disclosure (k) may be too costly to prepare and may not be relevant in all cases as merger accounting is not a fair value measurement. Same observation for Appendix 2.

Question 8

From your point of view, which areas of AG5:

(a) represent benefits to users of financial statements, preparers, auditors and/or enforcers of financial information, and why;

(b) have resulted in considerable unexpected costs to users of financial statements, preparers, auditors and/or enforcers of financial information, and why;

(c) have had an effect on how common control combinations are carried out (for example, an effect on terms or structure of the combination); or

(d) requires more general guidance for other areas of the consolidated financial statements, such as the cash flow statement and earnings per share?

Are there other matters that you think the HKICPA should be aware of as it considers the application of AG5? These matters may include, but are not limited to: (i) the usefulness of information provided by AG5; (ii) practical implementation matters; and (iii) any learning points for our standard-setting process.

Question 8(a) response

- The benefit of AG 5 is the concept of adopting predecessor accounting and preparers do not need to perform the fair value measurement required under acquisition accounting, which is normally time consuming and costly.
- In an IPO situation, the historical financial information during the track record period allows the users to assess the performance trends of the reporting entity.

Question 8(b) response

- Preparers may bear additional unexpected costs if:
  - No separate books and records for the combining businesses before the BCUCC.
  - No preparation of consolidated financial statements under HKFRS from the controlling party perspective in prior year.

Question 8(c) response

- AG5 may have impact on the deal structure. For example:
- There may be differences in using an existing entity and a new entity for reorganisation purpose, including the carrying amount of its existing books and records or from controlling parties' perspective; a disposal approach or a carve out approach for other businesses. A new entity can select its accounting policy on BCUCCs.
- Timing of reorganisation may drives different accounting treatment for the new reporting entity: Predecessor accounting if reorganisation is before the change of control or acquisition accounting as an extension of the acquirer if reorganisation is upon the change of control.

Question 8(d) response

We suggest to further consider:

- What constitute a common control business combination, especially for SoE and business transfer conditional upon an event resulting in a loss of control. (slide #15 - #16)
- What is recapitalisation. (slide #8)
- Should the restatement of comparatives be optional in both company and consolidation level. If necessary, regulatory body can provide specific guidance for capital market transactions to mandatorily restate comparatives. (slides #7, #17, #30, #33)
- The presentation of MI from the controlling party's perspective may not be relevant and meaningful in some situations. (slides #8-9, #18)
- Should the predecessor value at the ultimate controlling party's perspective be always used. (slide #10)

Question 8(d) response (Cont'd)

We suggest to provide additional guidance on:

- In Hong Kong and China, it is quite common that the reorganisation involving entities under the ownership of married couple and their children. Each of them individually has different equity interest in each entity before the reorganisation. Staff of the SEC may view businesses owned by married couple and their children or among living siblings and their children to be under common control provided that there are absences of contradictory evidences. Additional guidance on what factors should be considered in assessing common control for immediate family under HKFRS is helpful.
- Presentation of capital if consideration is in form of shares or guidance on how equity should be presented under Hong Kong Companies Ordinance.

Question 8(d) response (Cont'd)

We suggest to provide additional guidance on:

- Calculating earnings per share in the case of additional capital contribution from controlling party during the track record period. Whether shares issued upon the date of reorganisation should be retrospectively applied as if all shares had been injected from the date of common control or pro-rata on other basis, e.g. similar to bonus issue. There are also some complexity for the loan capitalisation upon the date of reorganisation and should substance be considered in the calculation of EPS.
- Preparing cash flow statements when the combining business itself is not a separate legal entity.
- How to account for the carrying amount of investment in subsidiary under BCUCC at company level?
- Additional disclosures for basis of preparation, including relevant allocation basis.